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TO RUEHC/SECSTATE WASHDC PRIORITY 8421
INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE PRIORITY
RUEHDX/MOSCOW POLITICAL COLLECTIVE PRIORITY
RHEBAAA/DEPT OF ENERGY WASHDC PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY
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C O N F I D E N T I A L SECTION 01 OF 03 MOSCOW 001198

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E.O. 12958: DECL: 03/20/2017

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SUBJECT: RUSSIA: PRIVATIZATION OF POWER SECTOR ON TRACK

REF: MOSCOW 00180

Classified By: Econ M/C Pamela Quanrud. Reasons 1.4 (b/d).

11. (C) Summary. Privatization of Russia's electricity power sector, the fourth largest in the world, is set to accelerate this year. Electricity monopoly RAO UES is currently preparing final reform measures needed to sell off its power companies to the private sector, and hopes to close its doors on schedule in 2008. UES says the Kremlin has endorsed plans to spin off companies and create a competitive electricity company. Sale of state-owned stakes in UES have been slotted for reinvestment in the federal grid system and hydroelectric plants, set to remain in state hands. Norilsk Nickel has become UES' first strategic investor, acquiring a 38 percent stake in UES' subsidiary, WGC-3, but many are vying for advantage. And even as they put the final touches on urgent reform measures, UES officials are also gaming out the sector's development after 2008. End Summary.

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BACKGROUND

12. (U) Privation of the electricity sector has been expected since 2003 when Russia passed the federal law "On Electric Power Industry" to break up state-owned electricity monopoly, RAO UES. Since then, the company has made steady progress on restructuring its power generation assets for privatization. UES's power companies produce 70 percent of the country's

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electricity. According to the 2003 law, the high voltage transmission grid, reorganized as the Federal Grid Company (FGC) and the system operator, which administers the wholesale market, are to remain under state control. In addition, GOR officials decided in 2004 against privatizing UES's hydroelectric plants, and, instead reorganized them

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under a single state-controlled holding company, Hydro-WGC. Most of UES's thermal power generation assets have been restructured into wholesale and territorial generating companies (WGCs and TGCs) and are in various stages of privatization.

13. (C) Privatization of UES is a fundamental part of broader electricity reform, which includes price liberalization. Since September 2006, a dual pricing system for the wholesale market has operated - 90 percent regulated and 10 percent

unregulated. Minister of Industry and Energy (MIE) Khristenko laid out a schedule last November to completely deregulate wholesale electricity prices by 2011. UES CEO Chubays and other UES officials have repeatedly told us the reform's main goals are to increase sector efficiency, stimulate investment, and provide reliable power supplies for its customers -- all through the creation of competitive markets in power generation, with restructured companies in private hands. (Comment: A recent series of Moscow Times articles inaccurately portray current privatizations as contrary to reform goals. Undoubtedly, UES officials are steering reforms through politically sensitive waters and corporate interests with Kremlin ties will become strategic investors in the sector, but UES officials are counting on the market structure and a sufficient number of players to guarantee competition. End comment.)

STRATEGIC INVESTORS JOCKEYING

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14. (SBU) Strategic investors in Russia's power sector are positioning themselves to acquire key power generation assets. As one industry analyst told us, strategic investors can be grouped into three categories. First, some power companies, including foreign firms like Finnish Fortum and Italian Enel, are seeking assets to position themselves in the market as electricity prices are deregulated. A second group of Russian industrialists, including metal companies, such as Interros and BASEL, are trying to secure a cheap source of electricity as liberalization increases cost outlays. As the primary supplier of fuel for Russia's power generation, Gazprom has an interest in diversifying the power sector's fuel mix to free up more gas for export. A third group of investors, including some Russian investment houses, are buying up stakes in expectation that increasing demand from the other groups will drive up the price.

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15. (C) On February 8, Gazprom announced that it had reached

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agreement with SUEK to combine their coal and power generation assets in a joint enterprise. Gazprom would hold a controlling 50 percent stake in the proposed company that would combine SUEK's coal and power assets and Gazprom's power generation assets. Economic reformers have raised concerns about the proposed deal. The news provoked strong negative reactions from MEDT Minister Gref, UES CEO Chubays, and FAS Head Artemyev. (Comment: This deal would be a major setback for market reformers in the government, who are trying to increase competition in the sector. According to industry analysts, the deal would give Gazprom control over power generation in Siberia and a third of the country's coal production. Vocal critics and less than full support for the venture on Gazprom's board suggest that this is far from a done deal. End comment.)

16. (SBU) On March 10, UES announced that eight "strategic" investors had submitted applications for a 38 percent private share offering for WGC-3. This is the first of many planned share offerings for single lot strategic stakes in UES's WGCs and TGCs. Although press reports speculate that Norilsk Nickel will receive the stake, UES Deputy Head of Strategy declined to comment on the winning investor and said that results of the offering would be made public March 21. UES plans to sell off a single lot 25 percent stake in WGC-5 this June.

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17. (C) For foreign strategic investors, opportunities for acquiring controlling stakes in UES's privatizations will likely be limited. Even as UES officials continue to tell us that foreign investors are welcome to participate in all upcoming share offerings, not one has so far succeeded in obtaining a controlling stake. In February, the press reported that Russian authorities would not allow Finnish energy concern Fortum to increase its current blocking stake in St. Petersburg's TGC-1 to a controlling stake because the

region is politically important. In another example, American Energy Systems (AES) told us in December 2006 that the GOR rejected its bid for a controlling stake in an Omsk power plant (reftel).

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POST-2008 POWER REFORM

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18. (C) Key to attracting strategic investors is to have a game plan for post-2008, and some type of assurance - beyond verbal promises - that reforms will stay on track. UES Deputy Head of Strategy Kachay told us that UES representatives in a March 7 meeting convened by Presidential Administration Head Sobyanin suggested forming an advisory body to oversee development in the power sector after UES's scheduled closure as a holding company in mid-2008. Kachay said that this "Market Board", which would include market participants, would establish unified standards and guidelines for market participation. The idea is to establish some mechanism to ensure the development of a competitive market when UES is gone. In another sign that UES officials want to maintain their influence after 2008, UES announced in February that strategic investors would be required to sign a memorandum with UES that obligates the new owners of WGCs and TGCs to follow through with investment plans drawn up by UES. (Comment: These initiatives represent an "insurance policy" that the sector will develop according to plan. End comment.)

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19. (C) UES is also seeking sources of investment capital for infrastructure assets that will not be privatized. On March 2, UES Board Directors approved a new reorganization scheme that would raise investment capital for the federal grid network and the GOR's hydroelectric plants by selling the state's stake in UES's daughter power generating companies. The plan involves creating two intermediate holding companies affiliated with the Federal Grid Company (FGC) and the Hydro-WGC that will manage the state's 52 percent stake in UES. These holding companies would direct proceeds from the

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state's stake in the privatized power companies to modernizing and expanding the federal grid system and investment projects for Hydro-WGC. The new scheme kills two birds with one stone. The state increases its stake in the FSC and Hydro-WGC to the legally required levels of 75 percent plus one share and 50 percent, respectively, and raises much needed investment capital for these two state-owned companies. Kachay told us that they have received the go-ahead for this new scheme from the Kremlin

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and relevant ministries.

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GAZPROM QUID PRO QUO?

110. (SBU) In a related development, Gazprom and UES on March 7 signed an agreement on long-term contracts to supply UES's power plants. Gazprom agreed to provide 103 bcm annually to UES's power companies (less than two thirds of their supply

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needs) until 2010 under the new regulated price schedule. UES would also purchase additional amounts at market prices

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from Russia's fledgling traded gas market (in which independent producers and Gazprom each offer half the volume on offer) that began trading in November. According to business daily Vedomosti, Gazprom CEO Miller put aside objections to UES's new reorganization plan in exchange for UES paying higher gas prices under these agreements. During

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the March 2 UES board meeting, Gazprom representative were the only ones who voted against the new reorganization plan.

According to the press, the new scheme would prevent Gazprom from directly swapping shares in UES for stakes in targeted power assets. Instead, it would be forced to deal with two intermediaries, FSC and Hydro-WGC, and pay market prices for these companies.

COMMENT

¶11. (C) Despite a few false starts and delays, privatization of Russia's electricity sector is surprisingly near. No official in a serious position in Russia seems to doubt the need for continued sector reform, further investment, and better efficiency in the electricity sector - and yes, for the Government to get out of electricity power generation. This is a positive trend against the backdrop of greater government ownership in the oil and gas sectors. Although foreign investors have not yet been allowed to acquire more than a blocking stake in a large power company, there is probably room for one or two major foreign players in the market -- and foreign competition would introduce more advanced technology and equipment and probably speed up modernization of Russia's dated infrastructure. But for the Kremlin, a heavy - i.e. controlling - foreign presence in such key sector would be tough to accept. What also remains in doubt is which owners will wind up holding the world's fourth largest electricity generating capacity. The outlines of tomorrow's winners will become clearer as this spring's share offerings play out and strategic investors, metal magnates, Kremlin proxies and Gazprom maneuver for advantage.

End comment.

BURNS